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IN THE

Supreme Court of the United States

October Term, 1970

No. 771

LOUIS BENEDEK and JANET BENEDEK,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

HENRY HIRSCH and MYRTLE G. HIRSCH,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ALEXANDER P. HIRSCH and MARY E. HIRSCH,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

MARTIN H. BENEDEK and LEONORE BENEDEK,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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IN THE

Supreme Court of the United States

October Term, 1970

Nos. .....

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LOUIS BEHREN and JANET BEHREN,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
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HENRY HIRSCH and MYRTLE G. HIRSCH,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ALEXANDER P. HIRSCH and MARY E. HIRSCH,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

MARTIN H. BEHREN and LEONORE BEHREN,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Louis Benedek, Janet Benedek, Henry Hirsch, Myrtle Hirsch, Alexander P. Hirsch, Mary P. Hirsch, Martin H. Benedek, and Leonore Benedek petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit entered in this cause July 1, 1970.*

Opinions Below

The opinion of the Tax Court (Appendix A, *infra*) is reported at 50 T.C. 732. The opinion of the Court of Appeals (Appendix B, *infra*) is not officially reported.

Jurisdiction

The decision of the Tax Court was entered on December 12, 1968. The judgment of the Court of Appeals was entered on July 1, 1970. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

Question Presented

The generally applicable rule, under the Internal Revenue Code, is that a distribution of cash to a long-term stockholder of a corporation having no accumulated or current earnings is deemed a return of his investment, and to the extent of any excess is taxed in the same manner as a long-term capital gain.

The same rule applies to a long-term stockholder of a so-called "collapsible" corporation unless more than 70 percent of the stockholder's gain is "attributable" to a "collapsible" asset, in which event the entire gain is taxed at ordinary income rates.

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* Consolidated proceedings were had below both in the Tax Court and the Court of Appeals. Accordingly, a consolidated petition is being filed herein.

The issue presented here—of substantial importance to the proper interpretation and application of the collapsible corporation provisions of the Internal Revenue Code—deals with the legal criteria to be applied in any given situation in determining whether gain is to be "attributable" to a "collapsible" asset or to a "non-collapsible" asset. Broadly stated, the issue is whether the Commissioner and the courts, in "attributing" gain to each of the two different classes of assets, are going to be required to apply the relevant Treasury Regulation, thus yielding a result consonant with economic and business reality, or are to be permitted to continue to apply an artificial, judicially created, rule of attribution which ignores completely the Treasury Regulations and bears no relationship to economic and business considerations.

In the context of the facts of this case, the precise issue is as follows:

> Where a collapsible corporation whose assets consist of newly constructed buildings (collapsible assets) and valuable long-term leaseholds (non-collapsible assets) distributes to its stockholders cash obtained from a mortgage loan secured by both the buildings and the leaseholds, and where the mortgage loan would not have been granted unless the leaseholds (non-collapsible assets) were given as security, may the gain to the stockholders upon such distribution be "attributable" to the buildings alone, or should the gain be "attributable" to both the buildings and the leaseholds.

The courts below held that no portion of the gain should be attributable to the leaseholds, with the result that the entire distribution of $3.1 million has been taxed at ordinary income rates rather than capital gains rates.

Statutes Involved

The statutes and regulations involved are Sections 115(d) and 117(m) of the Internal Revenue Code of 1939, as amended,* and Treasury Regulations 118 (1939 Code), Section 39.117(m)-1(c)(3)(ii).** The foregoing statutes and regulations are printed in full in Appendix C, *infra*.

Statement of the Case

The proceedings below were commenced by petitioners in the Tax Court to redetermine tax deficiencies for the calendar years 1950 and 1951 fixed by the Commissioner of Internal Revenue ("Commissioner") at $1,228,659.19.*** The deficiencies resulted from the Commissioner's treatment of certain cash distributions from five corporations, collectively referred to herein as the Farragut Corporations, as ordinary income under Section 117(m) of the Internal Revenue Code of 1939, as amended (hereinafter "Code"), rather than as gain from the sale or exchange of property under Section 115(d). The Commissioner's

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* Also cited as 26 U.S.C. §§115(d) and 117(m) (1952 ed.). These provisions are substantially embodied in Section 301(c) and Sections 341(a), (b)(1), (b)(2), and (d) of the Internal Revenue Code of 1954, as amended.

** These regulations are also found in Section 1.341-4(c)(2) of regulations promulgated under the Internal Revenue Code of 1954.

*** Said deficiencies are as follows:

Appellant	Deficiency 1950	Deficiency 1951
Louis Benedek and Janet Benedek	$16,203.88	$ 87,009.62
Henry Hirsch and Myrtle G. Hirsch	$95,681.63	$334,666.10
Alexander P. Hirsch and Mary E. Hirsch	$95,483.68	$338,079.94
Martin H. Benedek and Leonore Benedek	$48,796.25	$212,738.09

action was based upon his finding that the Farragut Corporations were so-called "collapsible corporations" and that the stockholders' gain was "attributable" exclusively to "collapsible" assets.

Inasmuch as the material facts are not disputed, they may be summarized with certainty as follows:

Petitioners owned 75 percent of the stock of the five Farragut Corporations and Newstrand Realty Corporation ("Newstrand").*

In 1947 Newstrand purchased approximately 26 acres of unimproved land in Brooklyn, New York. A portion of the land was sold to third parties or was condemned by the City of New York. The remaining land was divided into five tracts, each of which was leased by Newstrand to a Farragut Corporation for the purpose of constructing, operating, and managing housing projects, and securing Federal Housing Administration ("FHA") insured mortgage loans to finance the projects.

It was contemplated that the leasehold interests (and improvements to be constructed thereon) would be mortgaged and would constitute security for mortgage loans to be insured by the FHA. In order to assure that the leasehold interests would qualify as security for the mortgage loans under the applicable statute, the term of each lease was 99 years, with an option to renew for another 99 years. The FHA was precluded from issuing any mortgage loan unless the loan was secured by such a leasehold or by a fee simple, together with improvements to be erected thereon. 12 U.S.C. § 1736(a).

Applications filed by the Farragut Corporations with the FHA for mortgage insurance were approved; commitments were issued; and mortgage loans eventually were

* The remaining 25 percent of all six corporations was owned by an individual not involved in this proceeding.

made by an institutional lender in the aggregate amount of $21,719,300. The Farragut Corporation thereafter constructed 59 apartment buildings containing close to 2500 apartments at a total construction cost of $18,118,987.

From 1949 through 1951, the Farragut Corporations distributed a total of $3,158,000 to its stockholders. When such distributions were made, the Farragut Corporations had no accumulated or current earnings or profits. Thus, the cash distributed was obtained from the excess of mortgage loans over construction costs.

It is conceded that the Farragut Corporations were "collapsible corporations" within the meaning of the Code. It is also the fact that these corporations held both "collapsible" and "non-collapsible" assets. The newly constructed apartment houses, built at a cost of $18,118,987, constituted "collapsible" assets. The "non-collapsible" assets were the leasehold interests, which the Tax Court found and the Court of Appeals acknowledged, had a fair market value of $1,517,333 unrelated to actual or contemplated construction or improvements.*

Notwithstanding the facts (1) that the Farragut Corporations held "non-collapsible" property worth $1,517,333 for which Farragut had paid nothing; (2) that the "non-collapsible" property was security for the mortgage loans; and (3) that the newly constructed buildings were unprofitable and uneconomic in that the housing project continually suffered operating losses from 1949 through 1954; nonetheless, the courts below found that the entire gain realized by the Farragut stockholders from the $3.1 million cash distribution was "attributable" to the buildings alone ("collapsible" assets) and were not to be attributed in whole or in part to the leaseholds.

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* The Tax Court specifically found (11a, *infra*):

> "Thus, the petitioners have succeeded in establishing that the leases had a value of $1,517,333.00 which was not due to the construction of collapsible property."

Reasons for Granting the Writ

In holding that no portion of the gain realized upon the cash distribution was attributable to the "non-collapsible" leasehold property, the courts below departed completely from the mandate of the applicable Treasury Regulation and applied a judicially created, artificial rule of attribution which bears no relationship to economic reality and which does violence to the Commissioner's own promulgation.

That Regulation [Section 39.117(m)-1(c)(3)(ii) of Regulation 118] * is plain on its face and in meaning:

> ". . . [T]he gain attributable to the [collapsible] property . . . is the excess of the recognized gain of the shareholder . . . upon his stock in the collapsible corporation over the recognized gain which the shareholder would have if the property had not been . . . constructed . . ."

In the context of the case at bar where the undisputed facts are that (1) the taxpayers' basis of their stock in the Farragut corporations was zero, and (2) the corporations had no accumulated earnings or profits, the "recognized gain of the shareholder[s]" is precisely equal to their share of the $3.1 million distributed.** The "recognized gain which the stockholder[s] would have if the [collapsible] property had not been . . . constructed" is precisely equal to the taxpayers' share of the $1.5 million

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* Also cited as Section 29.117-11(c)(3), second paragraph, of Treasury Regulations 111, approved March 26, 1953 (T.D. 5999 at 1953-1 Cum. Bull. 187).

** Since there are no accumulated earnings or profits, the distribution is not a dividend. Section 115(a) of the 1939 Code. Since the basis of the taxpayers' stock is zero, the distribution is treated as a gain from the sale or exchange of property, Section 115(d), to the extent of the monies received by the taxpayer. Section 111.

fair market value of the leasehold interests.* The Regulation states that only the difference between these two figures is "attributable" to the collapsible property. Inasmuch as this difference ($1.6 million) is less than 70 percent of the total $3.1 million gain, the statutory exception to the general tax treatment of collapsible corporations is applicable, and the entire gain should have been taxed as a capital gain, not as ordinary income. See Section 117(m)(3) (B) of the 1939 Code.

The courts below ignored or paid only lip service to this controlling regulation. Rather, the courts applied an illusory, judicially created "source of funds" test, concluding that since the source of the corporate distribution was an FHA insured mortgage loan, all gain recognized by the taxpayers-recipients was *ipso facto* attributable to the newly constructed buildings only, and was not attributable to the leasehold interests. Alleged authority for the holdings below was found in a line of cases where, unlike the case at bar, not one taxpayer-stockholder was able to establish that the corporation had owned any "non-collapsible" asset to which gain could be attributed.

The result reached by the courts below completely vitiates the applicable Regulation, though it has never been suggested by the Commissioner or found by the lower courts that the Regulation is unreasonable or inconsistent with the Code, the only ground for overruling a regulation, *Bingler* v. *Johnson*, 394 U.S. 741 (1969); *United States* v. *Correll*, 389 U.S. 299 (1968); *Commissioner* v. *South Texas*

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* In order to determine what gain would have been recognized had the buildings not been constructed, it is necessary to assume a hypothetical state of facts; namely, (1) no construction, and (2) a distribution in kind of the leasehold interests in complete liquidation of the Farragut Corporations. Under Sections 111, 112, and 115(c) of the 1939 Code, the gain recognized on such a distribution (where the taxpayers' basis for their stock is zero, as here) is equal to the fair market value of the leasehold interests.

Lumber Co., 333 U.S. 496 (1948). Moreover, the lower courts' decisions fly in the face of the Congressional mandate (Section 117 (m)(3)(B)) that the gain herein should be taxed as a capital gain unless more than 70 percent thereof is attributable to collapsible assets. The admonition of this Court in *Bingler, supra,* at 306-307 bears repetition:

> "[W]e do not sit as a committee of revision to perfect the administration of the tax laws. Congress has delegated to the Commissioner, not to the courts, the task of prescribing 'all needful rules and regulations for the enforcement' of the Internal Revenue Code. 26 USC § 7805(a). In this area of limitless factual variations, 'it is the province of the Congress and the Commissioner, not the courts, to make the appropriate adjustments.'"

Instead of applying the Regulation promulgated by the Commissioner, the courts below in effect wrote a new regulation which confused the *condition or event* (construction) triggering the issuance of an FHA mortgage insurance commitment with the *assets* (buildings and leaseholds) securing the mortgage loan. The result of such confusion was that the lower courts substituted a cause-effect concept of "attribution" for the concept of "attribution" intended by the Code, as amplified by the Regulations; to wit, *allocation of the distributed proceeds in a real and economic sense,* to each of the assets (leaseholds and buildings) from which those proceeds are derived. Ironic in the lower courts' judicial legislation is that the very cause-effect standard created by them was itself misapplied. The basic premise of the Court of Appeals decision was: "without the construction there would have been no mortgage money to distribute" (19a, *infra*). It did not follow, however, that all gain *ipso facto* was to be attributable to the buildings; for it might have been said with equal validity, that without the renewable 99 year leaseholds as security, there would have been no mortgage money either.

12 U.S.C. § 1736(a). Simply stated, the approach taken below was legally and logically erroneous.

It is also clear that the decisions below lead to anomalous results. Had the Farragut Corporations never built the apartment house complex, their only assets would have been the leasehold interests worth approximately $1.5 million and for which the corporations had paid nothing. Had the leaseholds been mortgaged and the proceeds distributed (or had the leaseholds been distributed in kind), the stockholders would have recognized gain to the full extent of the proceeds or of the value of the leaseholds. The gain would clearly have been unrelated to construction of property and would have been taxed at capital gains rates. See Sections 111, 115(a), and 115(d) of the Code. The result should not differ merely because the mortgage on the land has been insured by the FHA. Yet, the consequence of the decisions below is that the irrelevant factor of the existence of FHA mortgage insurance has somehow eventuated in taxation of the gain at ordinary income rates, an unexpected result, particularly where substance takes precedence over form in matters of taxation. *Commissioner* v. *Court Holding Co.*, 324 U.S. 331 (1945).

Rigorous application of the relevant Regulation, logic, and economic good sense required that only so much of the $3.1 million distribution as exceeded the $1.5 million value of the leaseholds should have been "attributable" to the newly constructed buildings. This was not the result reached below, because the courts mistakenly considered as controlling the irrelevant fact that the FHA would not have issued a mortgage insurance commitment if construction of new buildings had not been contemplated. Instead, the courts should have deemed the applicable Regulation to be controlling, and recognized that the process of "attributing" gain is essentially an economic one of allocating gain to all assets which secured the mortgage, to wit, the leaseholds and buildings.

The Court of Appeals sought support for its holding in three prior decisions: *Short* v. *Commissioner*, 302 F.2d 120 (4th Cir. 1962); *Mintz* v. *Commissioner*, 284 F.2d 554 (2d Cir. 1960); and *Payne* v. *Commissioner*, 268 F.2d 617 (5th Cir. 1959). Unfortunately, none of these cases (and for that matter, no other case cited by the Tax Court) dealt with the issue raised at bar.* In *Mintz*, it was found that the increase in the value of land was due to the construction of apartments thereon and, therefore, gain was attributable to the buildings. No such situation exists at bar where, as expressly held by both courts below, the leaseholds had a value of $1.5 million unrelated to construction. Thus, in *Mintz* there simply was no non-collapsible asset to which gain could possibly be attributed, a state of facts not present here. In *Short*, the petitioners attempted to attribute gain to something which was not even an asset of the corporation, *i.e.*, something nebulously described by the Tax Court as the petitioners' "good fortune in being able to purchase the architects' [fellow stockholders'] stock at a low price." The Court properly dubbed the argument as "without merit". Finally, in *Payne*, the main issue was whether the corporation was "collapsible", a matter not raised here. Insofar as *Mintz*, *Short*, and *Payne*, in dictum, may possibly suggest that gain is to be attributed automatically to newly constructed buildings because without the construction, there would have been no FHA mortgage loan, such suggestion is as erroneous as the rationale below.

This Court has spoken on the issue of "attributing" gain to "collapsible" and "non-collapsible" assets on only one occasion. In *Braunstein* v. *Commissioner*, 374 U.S. 65

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* In not one prior case has the taxpayer established that the collapsible corporation owned "non-collapsible" property to which gain could be attributed. In the instant case, however, it has been specifically found that the corporations held non-collapsible assets worth $1.5 million having a zero basis.

(1963), a case which involved issues not raised herein, the Court stated in dictum at 374 U.S. 70:

> "If used in their ordinary meaning, the word 'gain' . . . simply refers to the excess of proceeds over cost or basis, and the phrase 'attributable to' merely confines consideration to that gain caused or generated by the property in question."

In the case at bar, the gain to petitioners was "caused or generated" by a mortgage on "collapsible" and "non-collapsible" property. Without *either* the leaseholds or the buildings, no mortgage would have issued. The problem of how to allocate the gain to each class of assets should have been resolved by application of the appropriate Treasury Regulation. The courts below failed to do this with the result that the Commissioner has been able to circumvent his own promulgation. Such a result should not be permitted.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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September 28, 1970.

APPENDICES

APPENDIX A

Memorandum Findings of Fact and Opinion

50 T. C. No. 71

TAX COURT OF THE UNITED STATES

LOUIS BENEDEK and JANET BENEDEK,[1]
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket Nos. 81900, 81901, 81902, 81903.
Filed August 12, 1968.

The petitioners formed corporations for the construction of an apartment housing project. The corporations borrowed $21,719,300 on F.H.A. insured mortgage loans to construct the project and expended in such construction a total of $18,118,987. The corporations distributed to their stockholders, among whom were the petitioners, a total of $3,158,000 in 1949, 1950, and 1951. At such times, the value of the leaseholds on which the project was constructed was $1,517,333.

Held: The corporations were collapsible corporations within the mean of sec. 117(m), I.R.C. 1939, and more than 70 percent of the gain recognized by the petitioners in

[1] Cases of the following petitioners are consolidated herewith: Henry Hirsch and Myrtle G. Hirsch, docket No. 81901; Alexander P. Hirsch and Mary E. Hirsch, docket No. 81902; and Martin H. Benedek and Leonore Benedek, docket No. 81903.

Appendix A

1950 and 1951 was attributable to the construction of the project. No part of such gain was attributable to the value of the leaseholds.

MARTIN C. BARELL, JACQUIN D. BIERMAN, and MARVIN B. TEPPER, for the petitioners.

JOHN B. MURRAY, JR., and JACK S. OLDER, for the respondent.

SIMPSON, *Judge*: The respondent determined deficiencies in income tax of the petitioners as follows:

Petitioners	*1950*	*1951*
Louis and Janet Benedek	$ 16,203.88	$ 87,009.62
Henry and Myrtle G. Hirsch ..	95,681.63	334,666.10
Alexander P. and Mary E. Hirsch	95,483.68	338,079.94
Martin and Leonore Benedek	48,796.25	212,738.09

The issue for decision is whether the Farragut corporations, of which the petitioners were stockholders and from which they received distributions in 1950 and 1951, were collapsible corporations within the meaning of section 117(m) of the Internal Revenue Code of 1939[2] and whether, for the purposes of the limitation in section 117(m)(3)(B), more than 70 percent of the gain recognized by the petitioners on such distributions was attributable to property constructed by the corporations.

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[2] All statutory references are to the Internal Revenue Code of 1939. In regard to distributions similar to those in this case under the Internal Revenue Code of 1954, see sec. 312(j) of such Code.

Appendix A

Findings of Fact

Some of the facts were stipulated, and those facts are so found.

All of the petitioners are individuals who were legal residents of New York, New York, at the time their petitions were filed in this case. Louis and Janet Benedek, Martin and Leonore Benedek, Henry and Myrtle Hirsch, and Alexander and Mary Hirsch are, respectively, husband and wife and filed their joint Federal income tax returns, using the cash receipts and disbursements method of accounting, for the taxable years 1950 and 1951 with the then collector of internal revenue for the first district of New York. Louis and Martin Benedek and Henry and Alexander Hirsch will collectively be referred to as the petitioners.

On September 3, 1947, Newstrand Realty Corporation (Newstrand) was incorporated in the State of New York. The common stock of Newstrand was owned 25 percent by Morris Kavy, 25 percent by Henry Hirsch, 25 percent by Alexander Hirsch, 16⅔ percent by Martin Benedek, and 8⅓ percent by Louis Benedek. Martin Benedek was president, Morris Kavy was vice-president, Henry Hirsch was second vice-president, Alexander Hirsch was treasurer, and Nathan Neitlich was secretary. All but Nathan Neitlich were members of the board of directors.

In 1947, the New York Water Service Corporation (Water Corporation), a regulated public utility, owned a substantial amount of property in Brooklyn, New York. The City of New York, through condemnation proceedings, took possession of a part of the Water Corporation's property on June 30, 1947. When the City took possession, the compensation to the Water Corporation had not been determined. The part taken by the City was the source of much of the earnings of the Water Corporation, which was also

anticipating at that time the maturity in 1951 of its first mortgage bonds. For these reasons, the Water Corporation decided to sell another large tract of its Brooklyn property.

Newstrand purchased such other tract from the Water Corporation at a price of $1,764,238.66 and acquired title on November 14, 1947. The tract contained a total of 1,144,525 square feet, of which 55,900 square feet was sold by Newstrand to third persons and 189,700 square feet was condemned by the City of New York.

On January 25, 1949, the following corporations were incorporated in the State of New York: Farragut Gardens No. 1, Inc.; Farragut Gardens No. 2, Inc.; Farragut Gardens No. 3, Inc.; Farragut Gardens No. 4, Inc.; and Farragut Gardens No. 5, Inc. Each of the Farragut corporations was owned by the same persons in the same proportions as Newstrand, and the officers and directors of the Farragut corporations were the same as the officers and directors of Newstrand. The purposes of the Farragut corporations were leasing the unimproved tract purchased by Newstrand from the Water Corporation, constructing, operating, and managing housing projects on this tract, and securing Federal Housing Administration (F.H.A.) insured mortgage loans to finance the projects.

Newstrand leased the tract to the Farragut corporations in five separate leases dated at various times from April 27, 1949, to October 4, 1949, for a total annual rental of $76,960. Each lease was prepared in accordance with lease forms prescribed by the F.H.A., and each was for a term of 99 years renewable at the option of the lessee for an additional 99 years at the same annual rental. The leases further provided that should the leasehold mortgage or the F.H.A. as mortgage insurer acquire title to the leasehold interests of the Farragut corporations because of a default by the lessee, the leasehold mortgagee or the F.H.A. could acquire the lessor's fee title in the land upon payment of

a fixed price, known as the "recapture price". The recapture prices for the land leased by the Farragut corporations totaled $1,924,000.

Under the terms of the leases, the net annual rental was fixed at 4 percent of the recapture price. During the years 1950 and 1951, and at all relevant times, such percentage was uniformly applied in F.H.A. leasehold projects.

The F.H.A. applications filed by the Farragut corporations were approved, commitments were issued by the F.H.A., and mortgage loans were made by the Manhattan Company and insured by the F.H.A. in the total amount of $21,719,300. The amount of a mortgage insured by F.H.A. was determined by reference to the replacement cost of the property; F.H.A. insured mortgages up to 90 percent of the total estimated replacement cost of the property. The value of the Farragut Gardens' leasehold interest did not influence the amount of the insured loan because it is not considered part of the replacement cost of the project.

The Farragut corporations constructed on their leaseholds 59 apartment buildings containing 2,496 apartments at a total construction cost of $18,118,987. Permanent certificates of occupancy, which evidenced completion of the buildings and authorized their occupancy, were issued by the Department of Housing and Buildings of the City of New York to each of the Farragut corporations on dates ranging from December 21, 1949, to July 10, 1951.

Distributions of $396,000.00 were made by the Farragut corporations to their stockholders in 1949. In 1950, the Farragut corporations made distributions of $50,000.00 to Louis Benedek, $100,000.00 to Martin Benedek, $150,000.00 to Alexander Hirsch, $150,000.00 to Henry Hirsch, and $150,000.00 to Morris Kavy. In 1951, the Farragut corporations made distributions of $180,166.67 to Louis Benedek, $360,333.33 to Martin Benedex, $540,500.00 to Alexander Hirsch, $540,500.00 to Henry Hirsch, and $540,500.00 to Morris Kavy. Total distributions by the Farragut cor-

porations in 1949, 1950, and 1951 were thus in the amount of $3,158,000.00. When such distributions were made, the Farragut corporations had no accumulated or current earnings or profits, and the corporations suffered operating losses from 1949 at least through 1954. They engaged in no business or activity other than the construction and operation of the apartment buildings on their leaseholds.

In 1955, civil actions were commenced in the United States District Court, Eastern District of New York, by Norman P. Mason in his official capacity of Federal Housing Commissioner and by the Farragut corporations against the petitioners, among others, as defendants. Such actions sought, among other things, the recovery of funds alleged to have been wrongfully paid and distributed by the Farragut corporations to the petitioners. On July 19, 1957, the actions were settled, and on August 27, 1957, the petitioners repaid $1,600,000 to the Farragut corporations.

Real estate taxes on property located in the City of New York are determined by applying a fixed rate to the assessed valuation of the property. The law applicable during the years involved in this case provided that City tax assessors should state "the sum for which, in their judgment, each separately assessed parcel of real estate would sell under ordinary circumstances if it were wholly unimproved; and separately stated, the sum for which the same parcel would sell under ordinary circumstances with the improvements, if any, thereon." Section 155b-1.0 of the Administrative Code of the City of New York (Chapter 929, Laws of 1937). The fiscal year of the City of New York for the purposes of assessing real estate taxes commences on July 1 and ends on the following June 30. The actual physical assessment of real property is begun in August, and the assessed valuation of such property is entered in the month of January, preceding the commencement of the fiscal year.

Appendix A

The market value of unimproved property in the Brooklyn area increased between 1948 and 1951. A number of factors, such as strong housing demand, increased availability of building materials, and liberalized Government housing programs contributed to the increases in market values. Such increases were reflected in increased valuations by the City of New York for purposes of real property taxation.

The tract leased by the Farragut corporations from Newstrand was assigned assessed valuations by assessors of the City of New York for the fiscal years beginning July 1, 1950, and July 1, 1951, of $2,971,000 for the land as if wholly unimproved. The Farragut corporations contested such valuations and after trial, the Supreme Court of New York fixed the value of the land as if wholly unimproved at $2,730,650 for the fiscal year beginning July 1, 1950, and $2,696,775 for the fiscal year beginning July 1, 1951.[3]

The fair market value of the tract leased by the Farragut corporations from Newstrand at the times the tract was leased in 1949 was $2,800,000. Based upon this fair market value of the tract, the fair market value of the leaseholds held by the Farragut corporations was $1,517,333 at the same dates.

OPINION

Our sole issue is whether the gains realized by the petitioners in 1950 and 1951 upon receipt of cash distributions from the Farragut corporations should be taxable as a return of capital since the corporations had no accumulated or current earnings and profits or whether such gains

[3] The valuation of one lot in the tract was not contested for the fiscal year beginning July 1, 1950, and the assessor's valuation for that lot was therefore applicable. The figure in the text for 1950 represents the total effective valuation for the tract.

should be taxable as ordinary income under the collapsible corporation provisions of section 117(m), which provide in part:

> SEC. 117. CAPITAL GAINS AND LOSSES.
>
> (m) Collapsible Corporations.—
>
> • • •
>
> (2) Definitions.—
>
> (A) For the purposes of this subsection, the term "collapsible corporation" means a corporation formed or availed of principally for the manufacture, construction, or production of property, • • • or for the holding of stock in a corporation so formed or availed of, with a view to—
>
> (i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the net income to be derived from such property, • • •

This case is one of a long line of cases in which a corporation received an F.H.A. insured loan in excess of the cost of construction and distributed the excess to its shareholders. E.g., *Max Mintz*, 32 T.C. 723 (1959), affd. 284 F. 2d 554 (C.A. 2, 1960); *Elizabeth M. August*, 30 T.C. 969 (1958), affd. 267 F. 2d 829 (C.A. 3, 1959); *Arthur Sorin*, 29 T.C. 959 (1958), affd. per curiam 271 F. 2d 741 (C.A. 2, 1959); *Raymond G. Burge*, 28 T.C. 246 (1957), affd. 253 F. 2d 765 (C.A. 4, 1958). From a reading of such cases, the Farragut Corporations appear to fit the definition of a collapsible corporation. Furthermore, since the respondent has determined that the Farragut corporations

come within the definition of a collapsible corporation, the petitioners have the burden of proving that the corporations are not collapsible; and since the petitioners have not denied that the corporations are collapsible, we assume, for purposes of this case, that they come within the statutory definition. *Arthur Sorin, supra.*

The petitioners have rested their case on the contention that section 117(m)(3)(B) applies in this case and makes section 117(m) inapplicable to the distributions received by them. Section 117(m)(3)(B) provides:

> (B) this subsection shall not apply to the gain recognized during a taxable year unless more than 70 per centum of such gain is attributable to the property so manufactured, constructed, produced, or purchased; * * *

Consequently, we must determine what percentage, if any, of the distributions to the petitioners from the Farragut corporations was attributable to the construction of apartment houses, and what percentage, if any, was attributable to an increase in value of the land or leaseholds on which the apartment houses were constructed. Land is not regarded as a collapsible asset, and hence a distribution attributable to an increase in value of land, unrelated to construction, would not be taxed according to the provisions of section 117(m). See, e.g., *Max Mintz, supra; Elizabeth M. August, supra; Arthur Sorin, supra.*

The petitioners argue that they purchased the land at less than fair market value, that the land then increased substantially in value, and that the Farragut corporations, due to the concern of the F.H.A. and the absence of arm's-length bargaining, were able to enter into very favorable leases of the land. Therefore, the petitioners argue, the leaseholds held by the Farragut corporations had substantial values, and more than 30 percent of the distributions made by the corporations was attributable to such values.

Appendix A

The petitioners purchased the land for $1,764,238.66. The purchase price may have been below the fair market value of the land. Certainly the land increased in value between the time of its purchase in 1947 and the time it was leased to the Farragut corporations in 1949. The leases favored the Farragut corporations considerably. On the basis of all of the evidence, including expert testimony, we have arrived at a value for the land in 1949, 1950, and 1951 of $2,800,000.00. In reaching this conclusion, we were impressed by the valuation of approximately $2,700,000.00 determined by the Supreme Court of New York for purposes of the property tax. However, we have increased that valuation by $100,000.00 since the Supreme Court's determination represents an aggregate of the values determined for a number of separate parcels of land and since the entire tract is worth more than the aggregate of the values for the included parcels. Also on the basis of expert testimony, we have determined that a fair annual rental for the land was $168,000.00, or 6 percent of its fair market value. Since the actual annual rental to the Farragut corporations was $76,960.00, the leases have a fair market value of $91,040.00 per year, or based on a capitalization rate of 6 percent (which we think is appropria , a total fair market value of $1,517,333.00. Thus, we agree with the petitioners as to the value of the leases.

The respondent argues that some or all of the increase in the value of the land between 1947 and 1949 was due to the proposed use of the land for the construction of a huge apartment house project. This Court has often held when an increase in value of land is due to the construction of apartments thereon, the gain is attributable to construction of property for purposes of section 117(m)(3)(B). *Glickman* v. *Commissioner*, 256 F. 2d 108 (C.A. 2, 1958), affg. a Memorandum Opinion of this Court; *Max Mintz, supra*; *Elizabeth M. August, supra*. However, the petitioners have established that in this case, the value of the

leases was not due to the contemplated use of the land. Thus, the petitioners have succeeded in establishing that the leases had a value of $1,517,333.00 which was not due to the construction of collapsible property.

The petitioners' argument is that the apartment buildings had no value in excess of the mortgage loans to which they were subject, and that since the leases had substantial value, the distributions must be attributable to the value of the leases. However, the petitioners have failed to prove that the value of the buildings did not exceed the mortgages. They furnished testimony showing that the buildings were unprofitable, and there were some statements that the buildings could not be sold for more than the mortgages. Yet, this evidence is insufficient to establish the fair market value of the buildings. It fails to show that their fair market value did not exceed the mortgage loans. Accordingly, the petitioners have failed to prove one essential fact on which their argument rests, but our decision is not based solely upon this failure of proof.

Even if the petitioners had proved that the buildings were not worth more than the mortgages, still they have failed to show that more than 30 per cent of the gain was attributable to the value of the leasehold interests. In *Braunstein* v. *Commissioner*, 374 U.S. 65, 70 (1963), the Supreme Court said "the phrase 'attributable to' merely confines consideration to that gain caused or generated by the property in question." Thus, the test is what caused the distributions, or what property—land or buildings—generated them?

The answer is clear: The distributions were caused by, and generated by, the construction of the apartment buildings. The Farragut corporations received loans totaling $21,719,300 as a result of the construction of the apartment buildings; had they not been built, the loans would not have been received. The amount of the loans was determined as a percentage of the replacement costs of the buildings,

and the amount was not affected by the value of the leasehold interests—it was not increased by reason of the valuable leases which the Farragut corporations held on the properties. The total construction costs were $18,118,987, so that during the years 1949, 1950, and 1951, the Farragut corporations received as loans $3,600,313 in excess of the costs of construction. During those same years, they distributed to the shareholders $3,158,000. It is clear that the distributions were derived from the surplus of the mortgages. Although the leases were valuable, there was no realization of such value so that none of the funds distributed were derived from the value of the leases. The petitioners have not shown any way in which the value of the leases made possible the distributions to the shareholders. On the contrary, all the evidence indicates that the distributions were generated by the construction of the apartment buildings. What this Court said in *Elizabeth M. August, supra,* is equally applicable to this situation. "Since the gain of the stockholders in the instant case was realized in toto by reason of the distribution from the surplus mortgage funds and the said surplus funds were available only because of the construction of the apartments, it would appear reasonable to ascribe the gain 'by way of cause' to the property constructed." (30 T.C. at 987). See also *Glickman* v. *Commissioner, supra; Payne* v. *Commissioner,* 268 F. 2d 617 (C.A. 5, 1959), affg. 30 T.C. 1044 (1958); *Max Mintz, supra.*

The petitioners argue at considerable length that they have proved facts which were not proved in the *Murray Sorin* case, 23 T.C.M. 524, 33 P.-H. Memo. T.C. par. 64,087 (1964), and that the regulations support their position. Section 29.117-11(e), Regs. 111, contains an example involving an F.H.A. financed project. In the example, there was a surplus of borrowed funds which was distributed to the shareholder. One of the facts in the example was that the constructed property increased in value. The

example concluded that the distributions were attributable to the construction of property. The petitioners in this case reason that since they have established that the value of the constructed property did not exceed the mortgages, and that there was an increase in the value of the leasehold interests, it follows from the example that the distributions are attributable to the leasehold interests. We do not agree with their reasoning. It does not follow that the example would have reached a different conclusion if the facts were changed. There is nothing in the example to indicate that if the building did not increase in value, but the land did, the distributions would be attributed to the land.

It is true that the petitioners in this case have proved that their leasehold interests had substantial value not attributable to the construction of the buildings, a fact not proved in the *Murray Sorin* case; nevertheless, for the reasons already given, we have concluded that the gain of the petitioners was not attributable to the value of the leaseholds. It does not necessarily follow that because the petitioners have proved the independent value of the leases, the distributions were attributable to the land.

In conclusion, we hold that the gains of the petitioners were attributable to the construction of the apartment buildings, collapsible property, and the regulations and precedents relied upon by the petitioners do not support their position.

In order to reflect uncontested adjustments in the notices of deficiency.

Decisions will be entered under Rule 50.

APPENDIX B

Opinion of Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 568-71—September Term, 1969.

(Submitted May 27, 1970 Decided July 1, 1970.)

Docket Nos. 33467-70

LOUIS BENEDEK and JANET BENEDEK,

Appellants,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

Before:

WATERMAN, FRIENDLY and HAYS,

Circuit Judges.

Appeals from decisions of the Tax Court, Charles R. Simpson, *Judge,* upholding the Commissioner in his determination of deficiencies under Section 117(m) of the Internal Revenue Code of 1939, 64 Stat. 934, in taxpayers' income tax returns for 1950 and 1951 totaling $1,228,659.19.

Affirmed.

ARTHUR C. SILVERMAN, New York, N. Y. (Golenbock and Barell, New York, N. Y., of counsel), *for Appellants.*

Appendix B

DAVID E. CARMACK, Attorney, Department of Justice, Washington, D. C. (Johnnie M. Walters, Assistant Attorney General, Lee A. Jackson, Harry Baum, Attorneys, Department of Justice, Washington, D. C., of counsel), *for the Commissioner.*

HAYS, *Circuit Judge*:

We are here concerned with appeals from four decisions of the Tax Court which present, in a consolidated brief and appendix, the single issue of whether the Tax Court erred in holding certain corporate distributions to be attributable to collapsible assets and therefore taxable to the recipients as ordinary income rather than as capital gains. The Tax Court upheld the Commissioner in his determination of deficiencies totaling $1,228,659.19 in taxpayers' income tax returns for 1950 and 1951.[1]

The facts are not in dispute.

Appellants, together with one other person not involved in the present litigation, owned all the stock of Newstrand Realty Corporation. In 1947 Newstrand brought an unimproved tract of land in Brooklyn at a price of $1,764,238.66. The tract contained a total of 1,144,525 square feet of which 55,900 square feet were sold by Newstrand and 189,700 square feet were condemned by the City of New York.

In 1949 the stockholders of Newstrand organized five corporations, called Farragut Gardens Nos. 1 to 5, for the purpose of leasing the land owned by Newstrand and constructing housing projects on this land. The Farragut cor-

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[1] Louis Benedek, Henry Hirsch, Alexander P. Hirsch and Martin H. Benedek are referred to as the taxpayers or the appellants since their wives are parties only because joint income tax returns were filed.

porations were to finance the projects through mortgages insured by the Federal Housing Administration.

The leases from Newstrand to the Farragut corporations, executed in 1949, were in the form prescribed by the FHA and were for a term of 99 years, renewable at the option of the lessees for an additional 99 years. The leases provided that should the mortgagee or the FHA acquire title to the leaseholds by reason of a default by the mortgagors, the mortgagee or the FHA could acquire the lessor's fee upon payment of a recapture price totaling $1,924,000.

Mortgages were negotiated in the total amount of $21,719,300 and were issued by the FHA. Under FHA policy the amount of the insured mortgages was equal to 90 percent of estimated replacement cost of the property. Thus the value of the leaseholds was not considered in computing the amount of the mortgages.

The Farragut corporations constructed 59 apartment buildings on the leased property at a total cost of $18,118,987.

In 1949, 1950 and 1951 the Farragut corporations distributed a total of $3,158,000 to the stockholders. At the time the distributions were made the Farragut corporations had no accumulated earnings. Indeed the corporations sustained operating losses at least through 1954. They were engaged in no activity other than the construction and operation of the apartment buildings.

The leaseholds for which the Farragut corporations had paid Newstrand "little or nothing" (apparently nothing) were found by the Tax Court to have a fair market value of $1,517,333 at the time of the distributions to stockholders. No part of this market value was attributable to the construction of the apartment buildings on the leaseholds. The leaseholds, the Tax Court found, would have had the designated market value if the land had remained unimproved.

Appendix B

The taxpayers reported the amounts received from the cash distributions of the Farragut corporations as capital gains. The Commissioner ruled that the distributions were taxable to the recipients as ordinary income. The Commissioner was upheld by the Tax Court which fixed the total of the deficiencies for 1950 and 1951 as $1,228,659.19.

The taxpayers concede that the Farragut corporations were "collapsible corporations" as defined by Section 117 (m) of the Internal Revenue Code of 1939, 64 Stat. 934 (now Int. Rev. Code of 1954, § 341), which provides that distributions by collapsible corporations shall be treated as ordinary income. Taxpayers contend, however, that the distributions they received come within the limitation provision of Section 117(m)(3)(B) which provides that the general rule of Section 117(m) "shall not apply to the gain recognized during a taxable year unless more than 70 per centum of such gain is attributable to the [collapsible property, i.e., here the apartments buildings]." The taxpayers claim that of the total cash distribution of $3,158,000, almost 50% ($1,517,333) is "attributable" to increase in the value of the leaseholds and not to the collapsible property.

There appears to us to be no special mystery about the word "attributable" as it is used in the statute. The question to be answered is "where did the money come from?" The answer will ordinarily be the source to which the gain is "attributable." Here it is perfectly clear that the money came from the FHA insured loans.[2] The distributions were made from the excess of the loans over the cost of building the apartments. The corporations had no other source of cash, since their operations of the apartment projects had resulted in a loss and they were engaged in no other business. Considered conversely the corporations' cash distributions could not have represented the value of the lease-

[2] Income arising from government insured loans is given special treatment under § 312(j) of the Internal Revenue Code of 1954.

holds because the profit on the leaseholds was not realized before or during the period of the distributions. Accepting, as we do, the findings of the Tax Court, the corporations had a valuable asset in the leaseholds and at some future time they might have realized on that asset, presumably by selling the buildings together with the leaseholds. If they did so they might have additional cash to distribute to the stockholders and the tax treatment of such a distribution would constitute a quite different question from that now before us.

As the court said in *Payne* v. *CIR*, 268 F.2d 617, 621 (5th Cir. 1959):

> "The funds which provided [the distributions] were a loan secured by the improved property. The only basis for the making of F.H.A. loans was the construction of rental property. Without the buildings there would have been no loan. Without the loan there would have been no redemption of the stock. We think the gain was 'attributable' to the property constructed. The same conclusion was reached in Glickman v. C.I.R., 2 Cir., 256 F.2d 108, where it was said on page 111:
>
> 'The petitioners further contend that the gains recognized on the cash distribution and the sale of stock are not within § 117(m) because at least 30% of those gains was attributable to appreciation of the land "apart from building construction." This is far too narrow an interpretation of the statute to be accepted. As to the cash distribution the Tax Court correctly held that all of it was directly attributable to the constructed property, since it was paid out of the funds advanced . . . on the F.H.A. mortgage.' "

See also *Mintz* v. *CIR*, 284 F.2d 554, 559-60 (2d Cir. 1960); *Short* v. *CIR*, 302 F.2d 120, 124-25 (4th Cir. 1962).

Appendix B

Appellants seek to rely for support for their position on Treas. Reg. 118, § 39.117(m)-1 (c)(3)(ii) (1953) which provides in pertinent part:

> "For the purpose of this limitation, the gain attributable to the property referred to in section 117(m)(2)(A) is the excess of the recognized gain of the shareholder during the taxable year upon his stock in the collapsible corporation over the recognized gain which the shareholder would have if the property had not been . . . constructed."

The answer to the contention based on this sentence from the Regulations is that, since without the construction there would have been no mortgaged money to distribute, there was *no* "recognized gain which the shareholder would have if the property had not been . . . constructed."

The decision of the Tax Court is affirmed.

APPENDIX C

Statutes

Internal Revenue Code of 1939, as Amended

§ 115(d)

Other distributions from capital. If any distribution made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not a dividend, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. This subsection shall not apply to a distribution in partial or complete liquidation or to a distribution which, under subsection (f) (1), is not treated as a dividend, whether or not otherwise a dividend.

§ 117(m)

Collapsible corporations.

(1) Treatment of gain to shareholders. Gain from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation, to the extent that it would be considered (but for the provisions of this subsection) as gain from the sale or exchange of a capital asset held for more than 6 months, shall, except as provided in paragraph (3), be considered as gain from the sale or exchange of property which is not a capital asset.

(2) Definitions.

(A) For the purposes of this subsection, the term "collapsible corporation" means a corporation formed or availed of principally for the manufacture, construction, or production of property, for the purchase of property

which (in the hands of the corporation) is property described in subsection (a) (1) (A), or for the holding of stock in a corporation so formed or availed of, with a view to—

(i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the net income to be derived from such property, and

(ii) the realization by such shareholders of gain attributable to such property.

(B) For the purposes of subparagraph (A), a corporation shall be deemed to have manufactured, constructed, produced, or purchased property, if—

(i) it engaged in the manufacture, construction, or production of such property to any extent,

(ii) it holds property having a basis determined, in whole or in part, by reference to the cost of such property in the hands of a person who manufactured, constructed, produced, or purchased the property, or

(iii) it holds property having a basis determined, in whole or in part, by reference to the cost of property manufactured, constructed, produced, or purchased by the corporation.

(3) Limitations on application of subsection. In the case of gain realized by a shareholder upon his stock in a collapsible corporation—

(A) this subsection shall not apply unless, at any time after the commencement of the manufacture, construction, or production of the property, or at the

time of the purchase of the property described in subsection (a) (1) (A) or at any time thereafter, such shareholder (i) owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation, or (ii) owned stock which was considered as owned at such time by another shareholder who then owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation;

(B) this subsection shall not apply to the gain recognized during a taxable year unless more than 70 per centum of such gain is attributable to the property so manufactured, constructed, produced, or purchased; and

(C) this subsection shall not apply to gain realized after the expiration of three years following the completion of such manufacture, construction, production, or purchase.

For purposes of subparagraph (A), the ownership of stock shall be determined in accordance with the rules prescribed by paragraphs (1), (2), (3), (5), and (6) of section 503 (a), except that, in addition to the persons prescribed by paragraph (2) of that section, the family of an individual shall include the spouses of that individual's brothers and sisters (whether by the whole or half blood) and the spouses of that individual's lineal descendants.

Regulations

Treasury Regulations 118 (1939 Code), § 39.117(m)-1(c)(3)(ii)

For the purpose of this limitation, the gain attributable to the property referred to in section 117(m)(2)(A) is

the excess of the recognized gain of the shareholder during the taxable year upon his stock in the collapsible corporation over the recognized gain which the shareholder would have if the property had not been manufactured, constructed, produced, or purchased. In the case of gain on a distribution in partial liquidation or a distribution described in section 115(d), the gain attributable to the property shall not be less than an amount which bears the same ratio to the gain on such distribution as the gain which would be attributable to the property if there had been a complete liquidation at the time of such distribution bears to the total gain which would have resulted from such complete liquidation.

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In the Supreme Court of the United States

OCTOBER TERM, 1970

No. 771

LOUIS BENEDEK and JANET BENEDEK, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

HENRY HIRSCH and MYRTLE G. HIRSCH, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ALEXANDER P. HIRSCH and MARY E. HIRSCH, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

MARTIN H. BENEDEK and LEONORE BENEDEK, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. App. 1a–13a) are reported at 50 T.C. 732. The

opinion of the court of appeals (Pet. App. 14a–19a) is not yet reported.

JURISDICTION

The judgments of the court of appeals were entered on July 1, 1970. The petition for a writ of certiorari was filed on September 29, 1970. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

Whether the courts below correctly sustained the Commissioner's determination that gains realized by petitioner-stockholders from cash distributions from collapsible corporations were attributable to property constructed by the corporations, with the result that the gains were taxable as ordinary income rather than as capital gains.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Section 117(m) of the Internal Revenue Code of 1939 are set forth in Appendix C to the petition (Pet. App. 20a–22a).[1] The pertinent provisions of the Treasury Regulations (Section 39.117(m)–1 of Treasury Regulations 118 (1939 Code)) are set forth in the Appendix, *infra*, pp. 11–12.

STATEMENT

Petitioners[2] in 1949 organized five New York corporations ("Farragut corporations") for the purpose

[1] Unless otherwise stated, all references are to the Internal Revenue Code of 1939.

[2] Louis Benedek, Henry Hirsch, Alexander Hirsch, and Martin Benedek are referred to as the petitioners, since their wives are parties only because joint income tax returns were filed. The cases were consolidated for hearing and decision in both courts below.

of leasing an unimproved tract of land from another corporation (Newstrand Realty) and constructing apartment housing projects financed through mortgages insured by the Federal Housing Administration (FHA).[3] Five leases from Newstrand to the Farragut corporations were executed in accordance with FHA requirements, each for a term of 99 years and renewable at the option of the lessee for an additional 99 years. The leases provided that should the mortgagee or the FHA as mortgage insurer acquire title to the leaseholds by reason of a default by the mortgagors, the mortgagee or the FHA could acquire the lessor's fee upon payment of a "recapture price" totalling $1,924,000. (Pet. App. 3a–5a, 15a–16a.)

Mortgages in the total amount of $21,719,300 were negotiated by the Farragut corporations with Manhattan Company and were insured by the FHA. Under FHA policy the amount of the insured mortgages was equal to 90 percent of estimated replacement cost of the constructed property. The value of the Farragut corporations' leaseholds did not influence the amount of the insured mortgage loans because it was not considered part of the replacement cost of the apartment buildings. (Pet. App. 5a, 16a.)

Between 1949 and 1951 the Farragut corporations constructed on their leaseholds 59 apartment buildings, at a total construction cost of $18,118,987 (Pet. App. 5a, 16a). During those years the corporations distributed to their shareholders $3,158,000, although

[3] Petitioners owned 75 percent of the stock of the Farragut corporations and Newstrand. Morris Kavy, not involved in this case, owned the other 25 percent. (Pet. App. 3a, 4a.)

they had no accumulated earnings and indeed suffered operating losses during this period (Pet. App. 5a–6a, 16a).

The leaseholds, for which the Farragut corporations had paid nothing, had at the time of the cash distributions to stockholders a fair market value of $1,517,333. No part of this market value was attributable to the construction of the apartment buildings on the leaseholds. (Pet. App. 7a, 10a–11a, 16a.)

Petitioners concede that the Farragut corporations were "collapsible corporations" as defined by Section 117(m) of the Internal Revenue Code of 1939, which provides that any gains on distributions to stockholders are taxable to them as ordinary income rather than as capital gains. However, petitioners claim that they come within the exception of Section 117(m)(3)(B), which provides that Section 117(m) is inapplicable unless more than 70 percent of the gain on a distribution is attributable to the constructed property, on the theory that more than 30 percent of the gains on the cash distributions was attributable to the increase in value of the leaseholds. Accordingly, they reported the gains as capital gains. The Commissioner determined that the gains on the cash distributions were attributable entirely to the constructed property, and were therefore taxable as ordinary income, and accordingly determined deficiencies for the taxable years 1950 and 1951 totalling $1,228,659.19. (Pet. App. 2a, 9a, 17a.) The Tax Court upheld the Commissioner's determination (Pet. App. 11a–13a), and the court of appeals affirmed (Pet. App. 17a–19a).

ARGUMENT

The decision below, affirming that of the Tax Court, is correct and is in accord with decisions in every other case involving substantially the same issue. Neither a conflict nor an important question is presented.

1. Petitioners attempt here to revive an issue which has long since been put to rest in similar "FHA windfall" cases involving cash distributions by a "collapsible corporation" to its stockholders out of surplus proceeds of FHA approved construction loans. Essentially the same argument which petitioners advance in an effort to bring their admittedly "collapsible corporation" within the limitation provision of Section 117(m)(3)(B) of the 1939 Code, so as to render the gain realized from the distribution taxable as capital gain rather than ordinary income, has repeatedly been rejected by the courts.

Prior to the enactment of Section 117(m) of the 1939 Code, stockholders who formed a corporation in order to construct property were able to extract the anticipated corporate profits at capital gain rates through a distribution by the corporation (or a sale or exchange of their stock) before the corporation had realized substantial net income from the project. To prevent this result Congress in 1950 added Section 117(m) to the 1939 Code (now 1954 Code Section 341).[4] The section is divided into three parts: sub-

[4] Message from the President Transmitting Request for a Revision of the Tax Laws (January 23, 1950), H. Doc. No. 451, 81st Cong., 2d Sess., p. 5; H. Rep. No. 2319, 81st Cong., 2d Sess., pp. 56–57, 96; S. Rep. No. 2375, 81st Cong., 2d Sess., pp. 45, 88. See *Braunstein* v. *Commissioner*, 374 U.S. 65, 68–71.

section (m)(1) taxes gain from a sale of stock of or a distribution from a "collapsible corporation," which would otherwise be taxable as capital gain, as ordinary income; subsection (m)(2) defines a "collapsible corporation" as one formed or availed of principally for the construction of property with a view to a distribution that would enable the stockholders to realize gain attributable to the constructed property prior to realization by the corporation of a substantial part of the net income to be derived from such property; and subsection (m)(3) places certain limitations on the application of the section. We are here concerned solely with the limitation provision of Section 117(m)(3)(B), which provides that Section 117(m) "shall not apply to the gain recognized during a taxable year unless more than 70 per centum of such gain is attributable to the [constructed] property." In *Braunstein* v. *Commissioner,* 374 U.S. 65, 70, this Court stated that the "phrase 'attributable to' merely confines consideration to that gain caused or generated by the property in question."

In harmony with the scheme of Section 117(m), its legislative history, the implementing Treasury Regulations (Appendix, *infra,* pp. 11–12), and the relevant decisions, both courts below correctly held that Section 117(m)(3)(B) is inapplicable to the instant case. It is undisputed that the Farragut corporations which the petitioners-stockholders formed to construct apartment houses were "collapsible corporations" as defined in Section 117(m); that the corporations made cash distributions to petitioners during the taxable years (1950 and 1951) out of the surplus proceeds of

FHA insured construction loans, *i.e.*, out of the borrowed amounts in excess of the actual construction costs; and that petitioners realized gains from such distributions. The Commissioner's determination that the entire gains were "attributable to the [constructed] property," and that consequently Section 117(m)(3)(B) was inapplicable, is in complete accord with the decisions in a series of cases presenting the same issue, and was properly sustained by the courts below. *Glickman* v. *Commissioner,* 256 F. 2d 108, 111 (C.A. 2); *Mintz* v. *Commissioner,* 284 F. 2d 554, 559–560 (C.A. 2); *Sorin* v. *Commissioner,* 271 F. 2d 741 (C.A. 2), affirming *per curiam* 29 T.C. 959; *Payne* v. *Commissioner,* 268 F. 2d 617, 621 (C.A. 5); *Burge* v. *Commissioner,* 253 F. 2d 765, 769–770 (C.A. 4); *Spangler* v. *Commissioner,* 278 F. 2d 665, 670 (C.A. 4), certiorari denied, 364 U.S. 825; *Short* v. *Commissioner,* 302 F. 2d 120, 124–125 (C.A. 4); *August* v. *Commissioner,* 267 F. 2d 829 (C.A. 3), affirming 30 T.C. 969, 986–987.

Here, as in the cited cases, the corporate distributions were made in cash out of surplus proceeds of construction loans; and here, as in those cases, all of the resulting gains realized by the recipient stockholders were attributable to the construction project, not to appreciation in the value of the land or leasehold on which the property was constructed. As both courts below held, and other courts have pointed out in similar cases (*e.g., Glickman* v. *Commissioner, supra,* p. 111; *Payne* v. *Commissioner, supra,* p. 621; *Mintz* v. *Commissioner, supra,* pp. 559–560; *Short* v.

Commissioner, *supra*, pp. 124–125), but for the construction there would have been no excess of loan proceeds over construction costs; but for such excess there would have been no cash distribution; and but for such cash distribution the taxpayers would not have realized the gains in question. Under the applicable decisions, not merely "more than 70 per centum of such gain," but *all* of such "gain" was "attributable to the [constructed] property" within the meaning of Section 117(m)(3)(B), thus rendering that limitation provision inapplicable.

2. Petitioners do not and cannot assert conflict with any other decision. Indeed, as shown by the above cited cases, the courts have uniformly rejected the interpretation of Section 117(m)(3)(B) urged by petitioners. There is no more reason for further review of the decision below than, for example, of the decision in the *Spangler* case, *supra*, in which certiorari was denied.

3. There is no merit in petitioners' contention (Pet. 7–8) that the decision below contravenes the applicable Treasury Regulations. See Section 39.117(m)–1(e) of Regulations 118 (1939 Code), Appendix, *infra*, pp. 11–12. Rather it is petitioners who would misapply them. The portion of the Regulations upon which petitioners rely (Section 39.117(m)–1(e)(3)(ii)) states that, for purposes of applying the 70 percent rule contained in 1939 Code Section 117(m)(3)(B), "the gain attributable to the [constructed] property * * * is the excess of the recognized gain * * * over the recog-

nized gain which the shareholder would have if the property had not been * * * constructed." Nothing in this statement or elsewhere warrants petitioners' self-serving assumption that the cash distributions they received from the Farragut corporations out of the surplus construction loan proceeds did not result in recognizable gain "attributable to the [constructed] property" within the purview of Section 117(m)(3)(B) and the Regulations. For gain to be "recognized" it must first have been "realized."[8] While petitioners may have had an unrealized gain attributable to appreciation in the value of the leaseholds upon which the constructed property (apartment houses) was placed, at no time during the taxable years was such appreciation converted into realized gain. In the words of the very regulation upon which petitioners rely, there simply was no "recognized gain which the shareholder [petitioners] would have [had] if the property had not been * * * constructed." See also, Section 39.117(m)-1(c)(3)(iii) of Regulations 118, Appendix, *infra*, p. 12. The only recognizable gain was the gain realized from the cash distributions made from the surplus construction loan proceeds. But for the construction loans, the Farragut corporations would have had no money to distribute, and the gain realized and recognized by petitioners on the cash distributions was

[8] The recognizable gain was the excess of the cash amounts distributed over petitioners' bases for their stock. See 1939 Code Sections 111, 115. The bases for their stock was zero (Pet. 7), and they reported the entire amount of the distributions as capital gains (Pet. App. 17a).

therefore "attributable" entirely to the "constructed property."[*]

4. The issue here presented, which arises under the 1939 Code, lacks importance for the future in view of the enactment of 1954 Code Section 312(j). That section specifically provides that a corporate distribution of the proceeds of a loan insured by the United States shall be taxable as ordinary income if the amount of the outstanding loan exceeds the adjusted basis of the property securing the loan. See S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 47, 251, 260.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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[*] Even assuming *arguendo* that some percentage of the gains in question was attributable to an increase in value of the land or leaseholds on which the property was constructed, the decision below is nevertheless entitled to affirmance on the separate ground—alternatively relied upon by the Tax Court (Pet. App. 11a)—that petitioners failed to meet their burden of proving that at least 30 percent of the gains was attributable to appreciation in land or leasehold values.

APPENDIX

Treasury Regulations 118 (1939 Code):

§ 39.117(m)-1 *Collapsible corporations*—(a) *In general.* Subject to the limitations contained in paragraph (c) of this section, the entire gain from (1) the actual sale or exchange of stock of a collapsible corporation, (2) amounts distributed in complete or partial liquidation of a collapsible corporation which are treated, under section 115(c), as payment in exchange for stock, and (3) a distribution made by a collapsible corporation which, under section 115(d), is treated, to the extent it exceeds the basis of the stock, in the same manner as a gain from the sale or exchange of property, shall be considered as gain from the sale or exchange of property which is not a capital asset.

* * * * *

(c) *Limitations on application of section*—(1) *General.* * * *

* * * * *

(3) *Seventy-percent rule.* (i) This section shall apply to the gain recognized during a taxable year upon the stock in a collapsible corporation only if more than 70 percent of such gain is attributable to the property referred to in section 117(m)(2)(A). If more than 70 percent of such gain is so attributable, then all of such gain is subject to this section, and, if 70 percent or less of such gain is so attributable, then none of such gain is subject to this section.

(ii) For the purpose of this limitation, the gain attributable to the property referred to in section 117(m)(2)(A) is the excess of the recognized gain of the shareholder during the

taxable year upon his stock in the collapsible corporation over the recognized gain which the shareholder would have if the property had not been manufactured, constructed, produced, or purchased. In the case of gain on a distribution in partial liquidation or a distribution described in section 115(d), the gain attributable to the property shall not be less than an amount which bears the same ratio to the gain on such distribution as the gain which would be attributable to the property if there had been a complete liquidation at the time of such distribution bears to the total gain which would have resulted from such complete liquidation.

(iii) Gain may be attributable to the property referred to in section 117(m)(2)(A) even though such gain is represented by an appreciation in the value of property other than that manufactured, constructed, produced, or purchased. Where, for example, a corporation owns a tract of land and the development of one-half of the tract increases the value of the other half, the gain attributable to the developed half of the tract includes the increase in the value of the other half.

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